

**INTERIM REPORT NO. 9**

**REPORT ON BREACH OF CONTRACT,  
FIDUCIARY DUTIES, AND PROFESSIONAL  
NEGLIGENCE BY VINSON & ELKINS LLP**

**REPORT OF THE  
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## I.

### INTRODUCTION

The San Diego City Attorney is issuing Interim Report #9 related to alleged unlawful acts and improper activities associated with the City of San Diego's pension crisis. In previous Interim Reports, the San Diego City Attorney addressed the substance of the alleged illegal acts and improper activities by City officials and outside consultants. In this, Interim Report #9, the City Attorney discusses the role of Vinson & Elkins LLP.

On 18 February 2004 the City of San Diego entered an agreement with Houston-based law firm Vinson & Elkins to investigate possible illegal activities by San Diego City officials involving the City's pension plan.

The firm's primary responsibility was to conduct an investigation intended to satisfy KPMG, the City's outside auditor, that an appropriate "illegal acts" investigation had been conducted by the City in conformance with applicable auditing standards. As detailed below, Vinson & Elkins failed to complete this task.

The firm was hired again by the City in October 2004 to conduct another investigation in conformance with the applicable auditing standards to reassure KPMG that "illegal acts" had not taken place. As this report will illustrate, Vinson & Elkins failed to complete task.

The City Attorney now concludes that Vinson & Elkins breached legal duties it owed to the City of San Diego. Vinson & Elkins' breach of legal duties to the City has been the proximate cause of substantial damages suffered by the City.

## II.

### CITY OF SAN DIEGO HIRES VINSON & ELKINS

The City of San Diego is facing a series of daunting political and financial crises that threaten its solvency. The myriad of problems are dominated by a pension deficit estimated between \$1.4 billion and \$2 billion resulting from a number of financial factors including, but not limited to, the creation of retirement benefits that the City Attorney contends are illegal.

These benefits are the result of two contingent, *quid pro quo* arrangements between the San Diego City Council and the San Diego City Employees' Retirement System (SDCERS). The potential magnitude of the pension debt – also called the unfunded liability – was discovered in late 2001. At that time, information about the growing nature of the shortfall was communicated to SDCERS and some City officials but hidden from the public.<sup>1</sup>

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<sup>1</sup> 3 December 2001 e-mail from Assistant City Auditor and SDCERS Board Trustee Teresa Aja Webster to SDCERS Administrator Lawrence Grissom and carbon-copied to City Human Resources Director and SCERS Board Trustee Cathy Lexin. RE: "earnings EEEK!" (Exhibit 1)

In January 2003, the Houston-based law firm of Vinson & Elkins LLP (“V&E”) was one of three firms that responded to a request for proposal to review the City’s newly created investor-information Web page to ensure conformance with securities regulations and industry guidelines. The Web page was designed to provide publicly accessible investor information, including the continuing disclosure of annual reports and related information. Based on the firm’s specialized experience and their bid to perform the services for the fixed fee of \$30,000, the City’s contract was awarded to Vinson & Elkins.<sup>2</sup>

In December 2003, the firm’s contract was amended to include additional consultation and legal services relating to the City’s Web site and “other disclosure-related issues as-needed for a period of two years” at a cost of no more than \$27,000.<sup>3</sup>

During this period – before the firm was hired to perform its illegal acts investigation – Vinson & Elkins interviewed key City employees who possessed in-depth knowledge of the pension system and the funding shortfall, and strategized with these individuals, some of whom would later be indicted, about what corrective efforts were or were not appropriate.<sup>4</sup> As will be explained in this report, months before the City hired Vinson & Elkins to conduct the illegal acts investigation, the firm had already formed important opinions about the appropriateness of the City’s response to the discoveries<sup>5</sup> and who had caused the problems in the first place.<sup>6</sup>

The City filed voluntary corrections to its Certified Annual Financial Report for the year ending 30 June 2003 (“CAFR”) in January 2004 and in March 2004, calling attention to debts, factual and other errors that were omitted from previously released financial disclosures.<sup>7</sup> The City has not issued a CAFR, or audit, since fiscal year 2002. The lack of audited financials, among other issues, has prevented the City from borrowing money in the public markets.

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<sup>2</sup> Request for City Manager Action, Agreement for Electronic Disclosure Counsel Services dated January 24, 2003; and Auditor’s Certificate number 2300865. (Exhibit 2)

<sup>3</sup> Request for City Manager Action; First Amendment to Agreement for Electronic Disclosure Counsel Services dated December 9, 2003; and Auditor’s Certificate number 2400703. (Exhibit 3)

<sup>4</sup> 26 November 2003 handwritten notes from former-Assistant City Auditor Teresa Aja Webster. (Exhibit 4)

<sup>5</sup> 26 November 2003 handwritten notes from former-Assistant City Auditor Teresa Aja Webster. (Exhibit 4)

<sup>6</sup> 26 November 2003 handwritten notes from former-Assistant City Auditor Teresa Aja Webster. (Exhibit 4)

<sup>7</sup> Municipal Secondary Market Disclosure. (Exhibit 5)

The filing of the voluntary disclosures raised concerns with the U.S. Securities and Exchange Commission (SEC) and the U.S. Attorney's Office. Both agencies launched investigations of the City.

In February 2004, the City Manager authorized the City to retain Vinson & Elkins to both provide assistance in performing a review of then-current and past financial disclosure practices, and to respond to the SEC inquiry. The City appropriated \$150,000 for this purpose.<sup>8</sup> The letter of engagement authored by Vinson & Elkins promised to:

- Perform an investigation with an "initial scope" that "will be agreed upon by separate cover;" and
- prepare a report that would "not be advocacy document," but would, according to Vinson & Elkins, be an "objective 'warts and all' report."<sup>9</sup>

Days before the City Council approved hiring Vinson & Elkins, former City Attorney Casey Gwinn issued an e-mail to Vinson & Elkins Partner Paul Maco stating that some City officials had raised concerns over the existence of a potential conflict by the firm completing an investigation while, at the same time, representing the City to the SEC. Gwinn wrote:

Pat [Frazier] and Ed [Ryan] also raised questions about your representation of the City since you were already assisting City staff on these issues. I don't see the legal issues, but Pat [Frazier] made the point that they were going to have you do an internal review and now you are 'investigating' the staff you have been working with.<sup>10</sup>

Maco responded that no conflict existed. He wrote in an 16 February 2004 e-mail:

We see no conflict in our serving in both the report capacity and as your SEC lawyer, rather it is complementary and will avoid doubling up cost. For example, we would not be able to do a thorough report unless we reviewed everything turned over to the SEC in any event. We would also be well positioned to engage in negotiations with the SEC staff upon completion of the report.<sup>11</sup>

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<sup>8</sup> Request for City Manager Action; Engagement letter dates 22 January 2004; and Auditor's Certificate number 2400800. (Exhibit 6)

<sup>9</sup> Request for City Manager Action; Engagement letter dates 22 January 2004; and Auditor's Certificate number 2400800. (Exhibit 6)

<sup>10</sup> 16 February 2004 e-mail from former-City Attorney Casey Gwinn to Vinson & Elkins Partner Paul Maco. Subject: "Re: Attorney-Client Communication". (Exhibit 7)

<sup>11</sup> 16 February 2004 e-mail from Vinson & Elkins Partner Paul Maco to former City Attorney Casey Gwinn. Subject: "Re: Attorney-Client Communication". (Exhibit 7)

Vinson & Elkins never delivered the promised “initial scope” for its investigation. Rather, the firm immediately started work and began billing the City, with the letter of engagement as its only agreement and written directive. Its first bill, submitted on 12 March 2004, after a month of work, was more than \$149,987.22, just \$12.78 less than the full contract amount.<sup>12</sup>

After discovering a series of errors by the auditing firm Caporicci & Larson on the 2002 CAFR, the City severed the business relationship with that firm. Although Caporicci & Larson had completed an audit for fiscal year 2003, the City hired KPMG to re-do the 2003 audit.<sup>13</sup>

Meanwhile, the City Council appropriated an additional \$350,000 in April 2004 for V&E to complete the report and for continued representation before the SEC.<sup>14</sup> The City Council appropriated an additional \$800,000 for Vinson & Elkins’ services in May 2004. Of that amount, \$500,000 was to additionally compensate Vinson & Elkins to complete the report and \$300,000 more to pay for representation of the City and a production of its documents before the SEC and the U.S. Attorney’s Office. At this time, the total cost of the legal services was not to exceed \$1.3 million.<sup>15</sup>

The City then tasked Vinson & Elkins to work with KPMG to examine the old financial data, ensure that all issues related to receiving an unqualified audit were addressed, and to identify and implement policies to ensure the errors would not occur in the future.

KPMG issued a letter to the City on 9 August 2004 that acknowledged the City’s directive for the firm to work with Vinson & Elkins. KPMG Partner Steven DeVetter wrote:

As indicated in our engagement letter dated April 13, 2004, we will not issue our auditors’ report until a determination is made that the investigation being conducted by V&E is sufficient and complete. We acknowledge V&E’s effort and cooperation in explaining the process they are undertaking to KPMG.<sup>16</sup>

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<sup>12</sup> 12 March 2004 invoice from Vinson & Elkins to Assistant City Attorney Les Girard; 1 April 2004 City of San Diego Request for Direct Payment; 12 March 2004 Outside Counsel Income Routing Slip. (Exhibit 8)

<sup>13</sup> 13 April 2004 letter from KPMG Partner Steven DeVetter to Lisa Irvine, director of the City’s Financial Management Department. (Exhibit 9)

<sup>14</sup> 12 April 2004. Resolution number 299077. Request for Council action; Auditor’s Certificate number 2400977. (Exhibit 10)

<sup>15</sup> 7 June 2004. San Diego City Council Resolution number 299313; 27 May 2004 Request for Council Action; Auditor’s Certificate number 2401131. (Exhibit 11)

<sup>16</sup> 9 August 2004 letter from KPMG Partner Steven DeVetter to Assistant City Attorney Les Girard. RE: Investigation. (Exhibit 12)

DeVetter also stated that the investigation being performed by Vinson & Elkins must include an analysis of whether any laws were violated.<sup>17</sup> DeVetter specifically asked Vinson & Elkins to answer a series of questions, including in pertinent part:

Did the SDCERS Board breach their fiduciary duty by allowing the City to underfund the plan in exchange for additional benefits for current employees and could this action have been in violation of any laws?...Did the City violate the City Charter by failing to fund its retirement plan as required by the City Charter?...Did the SDCERS Board and/or the City violate the California Constitution by allowing the City to intentionally underfund the Plan?...Was undue influence placed on the actuary to change assumptions to reduce the shortfall of the City's contribution compared to the ARC, and, if yes, at whose direction and what action does the City plan to take to rectify this action, if applicable?<sup>18</sup>

KPMG included with the letter a copy of the American Institute of Certified Public Accountants AU § 317, called "Illegal Acts by Clients."<sup>19</sup> The section outlines a set of specific accounting and investigative steps required to identify any illegal acts, the process used to carry out the acts, and the individuals who committed the acts.

By the end of August, the City Council authorized the expenditure of another \$700,000 for Vinson & Elkins, increasing the total cost of legal services to an amount not to exceed \$2 million.<sup>20</sup>

The relationship between V&E and KPMG did not go as planned. Less than one month after KPMG's letter was written on 9 August 2004, the firm issued another letter to the City on 1 September 2004 citing specific problems with the progress of Vinson & Elkins' work. Specifically, KPMG was concerned that the investigation failed to meet the comprehensive requirements outlined in previous communications. DeVetter wrote:

[W]e think it is fair to say that over [the last few months] we have expressed our concerns about the scope of the investigation as it has been described to us...[W]e remain concerned that the scope of the investigation may not be sufficient to

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<sup>17</sup> 9 August 2004 letter from KPMG Partner Steven DeVetter to Assistant City Attorney Les Girard. RE: Investigation. (Exhibit 12)

<sup>18</sup> 9 August 2004 letter from KPMG Partner Steven DeVetter to Assistant City Attorney Les Girard. RE: Investigation. (Exhibit 12)

<sup>19</sup> American Institute of Certified Public Accountants AU § 317. Illegal Acts by Clients. (Exhibit 13)

<sup>20</sup> 27 September 2004. Resolution number 299693; Request for Council Action dated 24 August 2004; Auditor's Certificate number 2500255. (Exhibit 14)

enable us to conclude that the City has adequately addressed certain issues pertinent to our audits...

[W]ithout in any way prejudging what our reaction to the final report will be, you should be aware that, if following our review of the V&E report we conclude that the V&E report is not sufficient to resolve all of the issues we face in the audit, we may advise you that additional investigative procedures may be necessary before KPMG can complete its work.<sup>21</sup>

KPMG effectively communicated its concern about the scope of the investigation to all parties in no uncertain terms. Thus, it is absolutely clear that Vinson & Elkins had substantial and repeated notice of KPMG's expectations.

Vinson & Elkins issued its report titled, "Report on Investigation: The City of San Diego, California's Disclosure Obligations to Fund the San Diego City Employees' Retirement System and Related Disclosure Practices," on 16 September 2004.<sup>22</sup> The report outlined two different agreements between the City Council and the SDCERS Board of Administration ("Board") as the primary sources of the pension deficit. These agreements provided for the SDCERS Board to accept underfunding of the retirement system in exchange for the City Council's agreement to grant enhanced pension benefits for City employees. The first deal, commonly referred to as Manager's Proposal I (MPI), was approved in 1996. The second deal, called Manager's Proposal II (MPII), was approved in 2002.

The report found that a series of disclosure violations had occurred. However, the report found "no evidence of affirmative deception," noting that those "individuals responsible for the City's disclosure lacked both motive and opportunity to mislead." Vinson & Elkins further found "no evidence that any City employees were personally enriched as a result of disclosure decisions in which they participated."<sup>23</sup> In the report's conclusion, Vinson & Elkins found it "difficult to attribute the City's failure to fully and accurately describe [this] matter to intentional misconduct on the part of individual employees."<sup>24</sup> In essence, Vinson & Elkins cleared all

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<sup>21</sup> 1 September 2004. Letter from KPMG Partner Steven DeVetter to Assistant City Attorney Les Girard. Re: "Follow-up from meeting on August 27, 2004". (Exhibit 15)

<sup>22</sup> 16 September 2004. Vinson & Elkins: Report on Investigation: The City of San Diego, California's Disclosure Obligations to Fund the San Diego City Employees' Retirement System and Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code. (Exhibit 16)

<sup>23</sup> 16 September 2004. Vinson & Elkins: Report on Investigation: The City of San Diego, California's Disclosure Obligations to Fund the San Diego City Employees' Retirement System and Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code. P. 6. (Exhibit 16)

<sup>24</sup> 16 September 2004. Vinson & Elkins: Report on Investigation: The City of San Diego, California's Disclosure Obligations to Fund the San Diego City Employees' Retirement System

individuals from purposefully committing any illegal activities but failed in any meaningful way to substantiate the basis for its conclusion.

KPMG immediately voiced concerns about the quality of the investigation and the resulting conclusions. The firm issued a letter to the City on 11 October 2004 that stated that the report was insufficient to meet professional auditing standards and that an “illegal acts” analysis was necessary for the audit to be completed. DeVetter wrote,

[W]e do not believe that the City of San Diego (“City”) has conducted an adequate investigation in order to conclude that likely illegal acts have not occurred, or that appropriate remedial action has been taken. Such an investigation is necessary in order for an auditor to complete an audit in accordance with generally accepted auditing standards and *Government Auditing Standards*.<sup>25</sup>

Vinson & Elkins immediately sought to downplay the criticism. Paul Maco, partner for Vinson & Elkins, issued a response to Assistant City Attorney Leslie Girard on 28 October 2004, stating that KPMG “fail[ed] to provide any practical guidance as to what additional investigative procedures [KPMG] would find satisfactory” for the completion of the 16 September 2004 report.<sup>26</sup>

The City Attorney believes that sufficient evidence exists to demonstrate that KPMG issued detailed “practical guidelines” for Vinson & Elkins to follow.

KPMG reasserted the need for an illegal acts investigation in a 29 October 2004 letter to former Mayor Dick Murphy.<sup>27</sup> DeVetter, in the letter, explicitly asked the City to contract with a firm other than Vinson & Elkins to complete this work. DeVetter wrote,

If the City is prepared to proceed with an appropriate investigation, then we urge you to consider retaining counsel other than V&E [Vinson & Elkins] to do so. The positions asserted in, and oppositional tone of, Mr. Maco’s letter raises questions about V&E’s willingness or ability in these circumstances to complete the investigation of, and reach conclusion on, the audit-critical questions posed in

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and Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code. P. 164. (Exhibit 16)

<sup>25</sup> 11 October 2004. Letter from Steven G. DeVetter to Leslie J. Girard. Re: City of San Diego Fiscal Year 2003 Audit. (Exhibit 17)

<sup>26</sup> 28 October 2004. Letter from Vinson & Elkins Partner Paul Maco to Assistant City Attorney Leslie Girard. Re: Additional Investigation. (Exhibit 18)

<sup>27</sup> 29 October 2004. Letter from KPMG Partner Steven DeVetter to Assistant City Attorney Leslie Girard. Re: Follow-up from meeting on August 27, 2004. (Exhibit 19)



our prior oral and written communications and to do so with an objective and independent manner.<sup>28</sup>

Despite KPMG's specific request, the City extended the contract with Vinson & Elkins to complete the investigation and to provide its analysis in a second report. While the prior resolutions adopted by the City required the City Attorney to enter into a contract with Vinson & Elkins, the City Manager's action of December 2, 2004, required the contract to be managed by the City Manager's office. Furthermore, Vinson & Elkins was to report directly to the Mayor with respect to the additional investigation.<sup>29</sup>

A new City Attorney, Michael Aguirre, was elected on 2 November 2004, in a tight election that required a complete vote count and took weeks to certify.<sup>30</sup>

Just days after the election results were announced, the City Council approved a resolution, on 23 November 2004, which expanded the scope of Vinson & Elkins' work to include "additional investigative services (are) now required to facilitate the completion of the audit of the City's FY 2003 basic financial statements" and stating that "additional contract authorization is necessary and appropriate to permit V&E to perform the additional investigation and to continue to provides representation of the City before the SEC".<sup>31</sup>

The new City Attorney took office on 6 December 2004. The new City Attorney immediately announced an investigation<sup>32</sup> and subsequently released a series of Interim Reports outlining alleged illegal acts that occurred in the approval of the Manager's Proposal I in 1996

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<sup>28</sup> 29 October 2004. Letter from KPMG Partner Steven DeVetter to Assistant City Attorney Leslie Girard. Re: Follow-up from meeting on August 27, 2004. (Exhibit 19)

<sup>29</sup> Request of City Manager Action dated 22 October 2004; Retainer Agreement on 15 October 2004; and Auditor's Certificate number 2500413. (Exhibit 20)

<sup>30</sup> Moran, Greg. "Aguirre wins S.D. city attorney race | Victory is his first in five tries for office." *San Diego Union-Tribune*. 20 November 2004. (Exhibit 21)

<sup>31</sup> San Diego City Council Resolution-299880 adopted on 23 November 2004. (Exhibit 22)

<sup>32</sup> 9 December 2004. Press release from the office of City Attorney Michael Aguirre. "Statement from City Attorney Michael J. Aguirre: Financial Disclosure Practices Investigation, and Decision Not to Join San Diego's Retirement System." (Exhibit 23)

and Manager's Proposal II in 2002. Interim Report #1 was issued on 14 January 2005<sup>33</sup> and Interim Report #2 was issued on 9 February 2005.<sup>34</sup>

The City Council then hired Los Angeles-based forensic accounting firm Kroll Inc. to reconcile the findings of Vinson & Elkins and the City Attorney. Troy Dahlberg, managing director of Kroll, issued a letter of engagement to the City on 10 February 2005. The Kroll scope of services was stated as follows:

“The City has requested that Kroll (1) receive, review and evaluate the findings of the investigations by VINSON & ELKINS and the City Attorney. The City has also requested Kroll provide consulting assistance in assessing internal control deficiencies affecting matters discussed in the investigation reports.”<sup>35</sup>

The letter mandates that Kroll's work must satisfy KPMG's audit requirements. Kroll specifically requested unfettered access to personnel and documents of the City, SDCERS, Vinson & Elkins, the City Attorney, and other potentially involved parties.<sup>36</sup> The City Council approved the Kroll contract at its 14 February 2005 meeting.<sup>37</sup> Kroll renamed itself The Audit Committee for these purposes.

At the 14 February 2005 City Council meeting, Lynn Turner, a consultant for Kroll, explained that Kroll would take the reports issued by the City Attorney and Vinson & Elkins, compare the data and findings, and issue its findings to KPMG.<sup>38</sup>

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<sup>33</sup> 14 January 2005. Interim Report No. 1 | Regarding Possible Abuse, Fraud, and Illegal Acts by San Diego City Officials and Employees. Report of the San Diego City Attorney Michael J. Aguirre. (Exhibit 24)

<sup>34</sup> 9 February 2005. Interim Report No. 2 | Regarding Possible Abuse, Fraud, and Illegal Acts by San Diego City Officials and Employees. Report of the San Diego City Attorney Michael J. Aguirre. (Exhibit 25)

<sup>35</sup> 10 February 2005 letter from Troy Dahlberg, managing director of Kroll, to Mayor Richard Murphy and San Diego City Council. Re: Independent Services for the City of San Diego. (Exhibit 26)

<sup>36</sup> 10 February 2005 letter from Troy Dahlberg, managing director of Kroll, to Mayor Richard Murphy and San Diego City Council. Re: Independent Services for the City of San Diego. (Exhibit 26)

<sup>37</sup> 14 February 2005 meeting of the San Diego City Council. (Exhibit 27)

<sup>38</sup> Transcript of Lynn Turner's presentation at the 14 February 2005 meeting of the San Diego City Council. (Exhibit 28)

On 1 March 2005, the City Council authorized the expenditure of another \$1.2 million for the work that Vinson & Elkins was performing. These funds, according to the language the City Council approved in the Resolution, were to come from the City's Enterprise Funds.<sup>39</sup>

Kroll and Vinson & Elkins began working together almost immediately. On 6 May 2005, Kroll issued a letter to City Manager P. Lamont Ewell explaining that materials compiled by Vinson & Elkins in the course of its investigations were useful. The letter was vague, however, as to whether Vinson & Elkins would issue a second report.

Questions have been raised as to whether or not Vinson & Elkins' work program will result in another report from that firm. The independent auditors have not specifically requested that from the Audit Committee.<sup>40</sup>

Despite noting the working relationship with Vinson & Elkins, Kroll continued to stress its independence.<sup>41</sup>

The letter suggests that Kroll was managing the work of Vinson & Elkins – a significant departure from Kroll's contractual obligation to analyze the Vinson & Elkins report. It is important to note that Vinson & Elkins' contact extension with the City required the production of a follow-up investigative report that would meet the standard of the American Institute of Certified Accountants § 317.

Kroll sent a letter to the City Council on 10 June 2005 further outlining its relationship with Vinson & Elkins.<sup>42</sup> Dahlberg wrote that the Kroll team had been reviewing the work plan laid out by Vinson & Elkins; examining documents collected, and would "provide V&E guidance as to the structure and format for presenting their findings and work product to KPMG." The letter also stated that Vinson & Elkins will issue a "summary memorandum" which will serve as a second report.<sup>43</sup>

On 1 August 2005, Dahlberg appeared before the City Council to request the Council waive the attorney-client privilege on documents that Vinson & Elkins obtained during its

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<sup>39</sup> San Diego City Council Resolution-300182 adopted on 1 March 2005. (Exhibit 29)

<sup>40</sup> 6 May 2005 letter from Troy Dahlberg, managing director of Kroll Inc., to City Manager P. Lamont Ewell. Re: Audit Committee – Investigation Status. (Exhibit 30)

<sup>41</sup> 6 May 2005 letter from Troy Dahlberg, managing director of Kroll Inc., to City Manager P. Lamont Ewell. Re: Audit Committee – Investigation Status. (Exhibit 30)

<sup>42</sup> 10 June 2005 letter from Troy Dahlberg, managing director at Kroll, to Mayor Richard Murphy. Re: Audit Committee – Investigation Status Update. (Exhibit 31)

<sup>43</sup> 10 June 2005 letter from Troy Dahlberg, managing director at Kroll, to Mayor Richard Murphy. Re: Audit Committee – Investigation Status Update. (Exhibit 31)

investigation. During Dahlberg's presentation, Councilmember Donna Frye asked a series of questions about the documents for which the privilege would be waived and to whom they would be presented. Dahlberg responded that the information was going to be presented to the SEC and KPMG. Dahlberg added that Kroll possessed in its ninth floor City Hall office a memorandum from Vinson & Elkins explaining the findings of its second investigation.<sup>44</sup> Both Frye and the City Attorney criticized the firms for not alerting the City Council to the existence of the draft Vinson & Elkins memorandum and requested a copy. Dahlberg provided a copy of the 116-page report to the Council and City Attorney.<sup>45</sup>

The new Vinson & Elkins memorandum, released to the public in the following days, found that the City failed to follow General Accepted Accounting Principles ("GAAP"). The report, however, cited no intentional wrongdoing or violations of law on the part of any individual City employees or City officials.

The additional evidence in our view, falls short of establishing that the City's flawed disclosure resulted from intentional wrongdoing on the part of City employees. The record does not indicate that any City employees, including its senior officers, suspected at any time that they were engaging in conduct that might be prohibited by law. Nor is there Available Evidence that any City employees consciously misled the City's auditors, outside counsel, or, indeed, anyone else.<sup>46</sup>

The report also concluded that:

The most damaging insight to come from this phase of the investigation is that certain officials consciously avoided bringing negative information to the attention of the bond rating agencies. There is no indication that they made false statements to the rating agencies, or evaded direct requests for information.<sup>47</sup>

As illustrated by California Civil Jury Instructions, 12.31, actual knowledge that representations are false and/or misleading is not required to demonstrate the act of fraud and/or deceit. Indeed, "false representations made recklessly and without regard for their truth in order to induce action by another are the equivalent of misrepresentations knowingly and intentionally uttered."<sup>48</sup>

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<sup>44</sup> Transcript of the 1 August 2005 meeting of the San Diego City Council. (Exhibit 32)

<sup>45</sup> 15 July 2005. Vinson & Elkins report: Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals. P.117. (Exhibit 33)

<sup>46</sup> 15 July 2005 V&E report, p. 117.

<sup>47</sup> 15 July 2005. Vinson & Elkins report: Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals. P.117. (Exhibit 33)

<sup>48</sup> *Engalla v. Superior Court* (1997) 15 Cal.4th 951, 974, quoting *Yellow Creek Logging Corp. v. Dare* (1963) 216 Cal.App.2d 50, 55.)

By this time, the City Attorney had released six Interim Reports alleging illegal acts by City officials surrounding Manager's Proposals I and II. The six reports contained footnotes and evidence to substantiate each claim and contained extensive appendices containing all footnoted documents.

On 6 January 2006 the U.S. Attorney's Office announced its indictments of three former trustees of the San Diego City Employee's Retirement System: Ron Saathoff, president of the San Diego Firefighters Association Local 145; Cathy Lexin, former Human Resources Director for the City; and Terri Webster, former assistant auditor and comptroller for the City. The indictments also named former SDCERS Administrator Lawrence Grissom, and Loraine Chapin, general counsel at SDCERS.<sup>49</sup>

### **III.**

#### **VINSON & ELKINS FAILED TO FULFILL CONTRACTUAL AND FIDUCIARY DUTIES OWED TO CITY OF SAN DIEGO**

Vinson and Elkins was under contract with the City of San Diego to produce a report that would satisfy concerns Indicated by KPMG. The evidence provided bellow will illustrate that:

- Vinson & Elkins Compromised its Independence
- Vinson & Elkins Failed to Complete Investigation Required by AU § 317

#### **A. VINSON & ELKINS COMPROMISED ITS INDEPENDENCE**

The primary objective of Vinson & Elkins' work for the City of San Diego was to create a completely objective report that would be independent in its preparation and unflinching in its criticism of the City.<sup>50</sup> However, Vinson & Elkins' independence was questionable as early as February 2005 and invoices submitted by Vinson & Elkins for May indicate that members of Kroll's team were working directly with Vinson & Elkins on preparing and drafting the law firm's second report. Indeed, evidence exists that Vinson & Elkins abdicated its independence in its relationship with Kroll.

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<sup>49</sup> 6 January 2006. United States District Court Southern District of California January 2004 Grand Jury: United States of America, Plaintiff, v. Ronald Saathoff (1), Cathy Lexin (2), Teresa Webster (3), Lawrence Grissom (4), Lorraine Chapin (5), Defendants. Criminal Case No. 06CR0043BEN. Indictment: Title 18, U.S.C., Sec. 371 – Conspiracy to Commit Wire and Mail Fraud; Title 18, U.S.C., Secs. 1343 and 1346 – Wire Fraud; Title 18, U.S.C., Secs. 1341 and 1346 – Mail Fraud; Title 18, U.S.C., Sec. 2 – Aiding and Abetting. 15 July 2005. Vinson & Elkins report: Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals. P.117. (Exhibit 34)

<sup>50</sup> Request for City Manager Action; Engagement letter dates 22 January 2004; and Auditor's Certificate number 2400800. (Exhibit 6)

On 16 February 2005, Lynn Turner sent an e-mail to City Manager Ewell explaining that Vinson & Elkins would, in effect, report directly to Kroll. Turner wrote, “Lamont – just to let you know I had a good call with Paul Maco yesterday and was able to communicate with Les Hand who was in NYC. Paul and I set up a reporting arrangement whereby he will report to us...”<sup>51</sup> The message was sent just days after the City Council approved the letter of engagement with Kroll in February and months before Vinson & Elkins released its second report. The message shows that Vinson & Elkins and Kroll were working closely since the beginning of Kroll’s work for the City.

In late May, Richard Sauer, a partner at Vinson & Elkins, spent 10 hours working on a “Draft report regarding securities law violations.” During this time – between 24 May 2005 and 31 May 2005 – Paul Maco spent more than 30 hours meeting with Kroll representatives. Sauer then met with the Kroll team on 27 May 2005 for 5.50 hours for “team conferences” and “draft memo.” Maco then met with the Kroll team on 31 May 2005 for 2.5 hours to “continue report preparation.”<sup>52</sup> Despite the work indicated on the billings, the second report from Vinson & Elkins would not be released until August.

## **B. VINSON & ELKINS FAILED TO COMPLETE INVESTIGATION REQUIRED BY AICPA § 317**

The second Vinson & Elkins report failed to meet the requirements of AU § 317, and meeting these requirements was explicitly required by KPMG. The standards specifically state:

.10 When the auditor becomes aware of information concerning a possible illegal act, the auditor should obtain an understanding of the nature of the act, the circumstance in which it occurred, and sufficient other information to evaluate the effect on the financial statement. In doing so, the auditor should inquire at a level above those involved...

.11 The additional audit procedures considered necessary, if any, might include procedures such as the following:

- a. Examine supporting documents, such as invoices, canceled checks, and agreements and compare with accounting records.
- b. Confirm significant information concerning the matters with the other party to the transaction or with intermediaries, such as banks or lawyers.
- c. Determine whether the transaction has been properly authorized.
- d. Consider whether other similar transactions or events may have occurred, and apply procedures to identify them.

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<sup>51</sup> 16 February 2005. E-mail from Lynn Turner to P. Lamont Ewell. Subject: San Diego. (Exhibit 35)

<sup>52</sup> 7 June 2005. Vinson & Elkins invoices to P. Lamont Ewell. (Exhibit 36)

## **1. Failure to Analyze City Council Member and Mayor Hard Drives**

Neither of the investigative reports prepared by Vinson & Elkins included an analysis of the computer hard drives of City Council members or their staffs, according to Paul Maco at the 9 August 2005 meeting of the City Council.<sup>53</sup>

## **2. Failure to Investigate Blue Ribbon Committee**

Vinson & Elkins' second report also failed to properly track down information following the questioning of key witnesses closely involved with the pension and the alleged failure to disclose information in financial statements. Specifically, the report discussed the Mayor's Blue Ribbon Committee on Finances report but failed to thoroughly investigate several inconsistencies between the final report and information that was known during its preparation. Vinson & Elkins describes the Blue Ribbon Committee report as, "The first significant warning as to the possible long-term consequences of the City's attempts to minimize its contributions and reported liabilities to SDCERS."<sup>54</sup> The Blue Ribbon Committee report was presented to the City Council's Government, Rules and Finance Committee on 27 February 2002.<sup>55</sup>

San Diego businessman Richard Vortmann was responsible for studying and writing the section of the Blue Ribbon Committee report focusing on the financial status of the pension system. Overseeing the work of Vortmann on the report were former City Auditor Ed Ryan and former Acting City Auditor Terri Webster. The second Vinson & Elkins report contains correspondence between Webster and Ryan illustrating repeated attempts to soften Vortmann's negative financial assessment.

Vinson & Elkins, however, did not adequately investigate the extent of the communications, or examine potential legal implications. Specifically, Vinson & Elkins failed to ascertain whether Ryan and Webster acted at the direction of other City officials.

In the Blue Ribbon Committee report, Vortmann correctly identified potential problems in the pension system including a growing liability for retiree medical care and the artificial health of the pension's funded ratio. Vortmann's report stated that, at the time, the funded ratio of SDCERS was 97 percent.

That information was inaccurate at the time of the presentation because the newest valuation for the SDCERS had been released to the Board on 12 February 2002 which pegged the funded ratio at 89 percent. The 97 percent funded number represented financial information

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<sup>53</sup> Transcript of the 9 August 2005 meeting minutes of the San Diego City Council. (Exhibit 37)

<sup>54</sup> Vinson & Elkins draft report titled "Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals. 15 July 2005. P. 45-50. (Exhibit 38)

<sup>55</sup> 27 February 2002. Blue Ribbon Committee Report on City of San Diego Finances. (Exhibit 39)

as of June 2000, while the 89 percent number reflected the newer, more accurate figures as of June 2001. The June 2001 valuation reflected a stunning increase in the pension's unfunded liability.

Vortmann was a member of the SDCERS Board in the months immediately preceding the presentation of the Blue Ribbon Committee Report and was privy to the new valuation, but made no effort to include the information before the hard copy of the report had been finalized and approved by the Rules Committee. Vinson & Elkins interviewed Vortmann and Terri Webster, former acting auditor for the City of San Diego, who oversaw the production of the report, about the failure to include the new numbers.

In an interview with VINSON & ELKINS, Mr. Vortmann stated that he could not recall whether he received and read the FY 2001 actuarial report prior to the publication date of the Blue Ribbon Committee Report but, in any event, found that it simply confirmed his view that FY 2001 would bring further decline in the funded level. Thus, in Mr. Vortmann's view, it did not materially affect the overall presentation of the report. Ms. Webster told V&E that she remembered some discussion among members of the Blue Ribbon Committee about including the updated number, but believes this was not done because, among other things, the actuary's report had not yet been accepted by the SDCER Board."<sup>56</sup>

The Vinson & Elkins report, however, also included a letter that Vortmann had written on 18 February 2002 to Frederick Pierce IV, then president of the SDCERS Board, where the new actuarial valuation was discussed. Therefore, this information was discussed by Vortmann in a letter to Pierce nearly two weeks before the Blue Ribbon Committee Report was released but was not included in the Report. Vinson & Elkins and Kroll, who oversaw the writing of the second V&E Report, failed to adequately investigate why the information was not presented to the City Council Rules Committee.<sup>57</sup>

The City Attorney believes that the newest information regarding the decreasing financial health of the pension system should have been included in the report as stated in the City Attorney's Interim Report #2.

The second Vinson & Elkins report also overlooked an important piece of evidence that was subsequently discussed in the City Attorney's Interim Report #2. Interim Report #2, released on 9 February 2005, identified an e-mail exchange between Ed Ryan, Terri Webster, and two of the City's labor negotiators, Dan Kelly and Mike McGhee. The topic of the correspondence is the "presidential benefit" that Ron Saathoff, as president of San Diego Firefighters Union Local 145, would receive as part of the Manager's Proposal II deal. In

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<sup>56</sup> Vinson & Elkins draft report titled "Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals". 15 July 2005. P. 44-50. (Exhibit 38)

<sup>57</sup> Vinson & Elkins draft report titled "Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals". 15 July 2005. P. 44-50. (Exhibit 38)



addition to being the union president, Saathoff was also a member of the SDCERS Board. In short, the e-mail illustrates that Saathoff, the City and the retirement board members were all aware that the boosting of retirement benefits was contingent upon the SDCERS Board allowing the City to underfund the pension. McGhee wrote to Ryan, Webster and Kelley, "I assure you that Ron is well aware of the contingent nature of the benefits."<sup>58</sup>

This information was not even mentioned in the second Vinson & Elkins report. In fact, the report stated that no evidence existed to establish a quid pro quo or contingent arrangement in the passage of Manager's Proposal II. Vinson & Elkins wrote, "A link between MP2 and the Union Presidents' Resolution is not clearly established by the evidence available to us at this time. The San Diego District Attorney has charged Mr. Saathoff (and others) with a conflict of interest in voting in favor of MP2, in part due to an alleged link between that measure and the union presidents' benefit."<sup>59</sup>

The complete failure to identify and discuss this factual finding in the illegal acts analysis demonstrates Vinson & Elkins' failure to satisfy its contractual obligation to provide an objective report.

### **3. Failure to Analyze Electronic Documents Provided by NTI Breakwater**

In order to make the production of documents more efficient, Vinson & Elkins used electronic discovery software from NTI Breakwater to create an electronic document repository, which was maintained by Applied Discovery, a subsidiary of Lexis-Nexis.

The City's e-mail system uses a software program called GroupWise, made by Novell Inc. This software is proprietary and GroupWise emails cannot be viewed by other computer programs.

NTI Breakwater was hired to convert the GroupWise files to ones that could be opened and viewed by other computer programs.<sup>60</sup> The converted files were placed in a database accessible to KPMG and federal investigators. In this database, the documents could be opened and viewed.

As early as January 2005, officials at Applied Discovery, KPMG and Vinson & Elkins realized that some of the attachments to documents had not been converted and placed in the database. In other words, if an e-mail, or "parent," had an attachment, or "child," the parent

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<sup>58</sup> 21 May 2002 E-mail from Labor Relations officer Mike McGhee to Ed Ryan, city auditor; Terri Webster, assistant city auditor; and Dan Kelley, labor relations manager. (Exhibit 40)

<sup>59</sup> Vinson & Elkins draft report titled "Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals. 15 July 2005. P 60-63. (Exhibit 41)

<sup>60</sup> 22 November 2004. City of San Diego consulting engagement agreement with NTI Breakwater. (Exhibit 42)

would appear in the Applied Discover database but the child was missing. Kelli Clark, an account manager at Applied Discovery, spotted the issue and forwarded the information in an e-mail:

I had our production team look into doc 206722 at KPMG's request. When our team looked at the pre-converted document, the links to the attachments were "dead." Hence, the attachments are not extracted and linked to the e-mail on the ORA. Additionally, when we look at doc #125481 (the number of the attachment that you provided today) there is no evidence that this document is an attachment to any other doc in the system.<sup>61</sup>

Investigators at the SEC had already identified this issue according to an e-mail sent from Ben Lippard, an attorney at Vinson & Elkins to Paul Maco. Lippard wrote:

There was only one issue of any real importance on the call today – the SEC was concerned about the fact that from applied discovery database you can't tell which file attachments belong to which emails. I have instructed Kelli to consult with Anton about a technical fix to this issue, which it seems likely they will insist on.<sup>62</sup>

This was a problem because the SEC and KPMG had both repeatedly asserted the need to see all documents requested to ensure that alleged improprieties that were responsible for the City's current financial difficulties would not happen again. If some of the e-mails and other electronic documents were not available, the investigation could not be adequately completed.

The problem was solved by Applied Discovery and NTI Breakwater on 2 May 2005 and a solution was presented to KPMG and the SEC in May. Kelli Clark wrote, "Ok. FYI – I just got word from our tech department that the family groups work is complete now. Whenever you give the go ahead, we are ready to begin the transfer."<sup>63</sup>

City Manager Lamont Ewell released a memo on 8 September 2005 stating that Vinson & Elkins had failed to review more than 57,000 files of the 160,000 relevant documents.<sup>64</sup> Ewell wrote that technology had broken down and blamed Vinson & Elkins for overseeing the maintenance of the issue. Ewell wrote:

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<sup>61</sup> 10 January 2005. E-mail from Kelli Clark to Ben Lippard. (Exhibit 43)

<sup>62</sup> 8 February 2005. E-mail from Ben Lippard to Paul Maco. Carbon-copied to Rick Sauer and William Lawler. Subject: Update on SEC call. (Exhibit 44)

<sup>63</sup> 2 May 2005. E-mail from Kelli Clark to Ben Lippard. Subject: RE: Transfer of data to a new database for the SEC. (Exhibit 45)

<sup>64</sup> 8 September 2005 letter from City Manager P. Lamont Ewell to Paul Maco, partner for Vinson & Elkins. (Exhibit 46)

The failure to include these files on the database has delayed the City's production of documents to the SEC and the United States Attorney's office. In addition, this error has caused the City to incur significant costs in having the missing files restored, and costs associated with a complete review of emails required by the Audit Committee, in addition to the attorneys' fees and expenses associated with creating and reviewing the original database. It is my belief that V&E [Vinson & Elkins] was responsible for providing instructions to and supervising the work of ADI as part of its investigation and report to the City on disclosure matters.<sup>65</sup>

The next day, on 9 September 2005, Scott Nagel, the Vice President of Applied Discovery, sent a letter to Lamont Ewell stating that the problems had been identified in January and corrected in June.<sup>66</sup> Nagel said that the staff of Applied Discovery had notified the City that the problems were corrected and that the City did not want the corrections implemented. Specifically, Nagel wrote that the City ordered the corrections not to be implemented. Nagel wrote:

Upon discovery of this issue in January, ADI offered to resolve the issue. At the time, ADI was told that the resolution it offered was unnecessary for purposes of the review work being performed. Later, in the April/May timeframe, ADI was asked to resolve part of the issue that had been created (i.e., repairing links between documents already in the database) for purposes of preparing a production database for the City. ADI did so, and also offered to resolve the remainder of the issues (i.e., ensuring that all family members of relevant documents were also included in the database) by re-running searches on the City's behalf. ADI was told not to re-run the searches.<sup>67</sup>

#### **4. Failure to Report Problems with Outside Disclosure Counsel**

For two decades Orrick Herrington & Sutcliffe ("Orrick") has served as the City's outside bond and disclosure counsel on many of the City's bond offerings. Orrick has been the City's most-hired law firm to lead municipal financing efforts and to serve as disclosure counsel regarding the sufficiency of the City's disclosures.

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<sup>65</sup> 8 September 2005 letter from City Manager P. Lamont Ewell to Paul Maco, partner for Vinson & Elkins. (Exhibit 46)

<sup>66</sup> 9 September 2005. Letter from Scott Nagel, vice president of Applied Discovery, to P. Lamont Ewell. (Exhibit 47)

<sup>67</sup> 9 September 2005. Letter from Scott Nagel, vice president of Applied Discovery, to P. Lamont Ewell. (Exhibit 47)

During seven of those years, all of the City's Official Statements contained a nearly identical pension disclosure in Appendix A. Under the heading "PENSION PLAN," the text stated:

State legislation requires the City to contribute to [SD]CERS at rates determined by actuarial valuations.

Vinson & Elkins interviewed Paul Webber, an Orrick attorney who served as bond and disclosure counsel for many City bond offerings. When asked, Webber was not able to identify the state legislation to which this sentence refers. Vinson and Elkins' report is silent on how Webber and Orrick could not understand their own disclosure statement.

Rather than explore the obvious problem with Orrick's disclosure statements, Vinson & Elkins accepted as true Orrick's denial of knowledge of the pension underfunding before the 5 September 2003 e-mail from Diann Shipione to Lawrence Grissom (with copies to Dick Murphy, Rick Roeder and Fred Pierce) alleging serious disclosure problems with City bond offerings.

The evidence available to Vinson & Elkins showed undeniably that Orrick knew well before September 2003 that the City was not complying with the legal requirements on funding its pension obligations. For example, Orrick obtained the SDCERS pension system's actuarial valuation for 2001, wherein the actuary explicitly stated that the City was not funding SDCERS based on actuarially required rates. The valuation states:

Overall, the financial condition of the retirement system continues to be in sound condition in accordance with actuarial principles of level-cost financing. However, we want all parties to be acutely aware that the current practice of paying less than the computed rate of contribution or pickup will help foster an environment of additional declines in the funding ratios in absence of healthy investment returns.<sup>68</sup>

This warning shows that the City's pension funding was materially different than what years of Orrick-prepared bond offerings declared was legally required.

Orrick not only possessed the 2001 valuation but, by March 2002, it pursued City staff with certain questions about its contents.<sup>69</sup> Orrick originally posed questions to Lakshmi Kommi, an analyst in the City's Financial Services Department. Webber admitted in an interview with Vinson & Elkins that "[h]e obtained some projections related to the UAAL from Ms. Kommi."<sup>70</sup>

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<sup>68</sup> 2001 San Diego City Employees' Retirement System Actuarial Valuation. P. 17. (Exhibit 48)

<sup>69</sup> 18 March 2002. E-mail from Patrick Lane to Larry. Subject: "FY2001 acturial [sic] valuation". (Exhibit 49)

<sup>70</sup> 11 July 1004. Memorandum from Tim J. Deithloff to Paul S. Maco. Re: "*City of San Diego*; Interview of Paul Webster". (Exhibit 50)

Mr. Webber also admitted to Vinson & Elkins that he looked at the City's pension disclosures in 2002.<sup>71</sup>

Webber could not do the things he told Vinson & Elkins he did in 2002—review the UAAL projections and look at the City's pension disclosures—and not be aware that the City was underfunding the retirement system. Incredibly, Webber told V&E that Orrick did not discover the funding problem until September 2003, 18 months after Webber must have been aware of the problem. V&E was derelict in failing to question this glaring inconsistency regarding Webber and the Orrick firm.

The next year, in June or July 2003, Webber received the actuary's report, which included the SDCERS 30 June 2002 valuation. Webber admitted to Vinson & Elkins that he had the 2002 SDCERS valuation by June or July 2003—earlier than September 2003 when he acknowledged that Orrick was aware of the funding problem and six months before Shipione's e-mail.<sup>72</sup> The 2002 valuation showed a UAAL of about \$700 million—nearly triple the year before. This time, Rick Roeder, the SDCERS actuary, declined to describe the pension fund as actuarially sound. Instead, he described the condition of SDCERS as “adequate”:

Overall, the financial condition of the retirement system is in adequate condition in accordance with actuarial principles of level-cost financing. However, all parties should be acutely aware that the current practice of paying less than the computed rate of contribution will help foster an environment of additional declines in the funding ratios in the absence of healthy investment returns.<sup>73</sup>

Orrick admitted to Vinson & Elkins that it was in possession of the actuarial valuation in the summer of 2003 and therefore must have known that the pension underfunding was material and required disclosure.<sup>75</sup> Webber further admitted that he would have determined the City's pension underfunding to be material even if Diann Shipione had not exposed the problem:

Mr. Webber believed that even if Diann Shipione hadn't come along, he would have discovered the City's pension situation (both retirement benefits and post-

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<sup>71</sup> 11 July 1004. Memorandum from Tim J. Deithloff to Paul S. Maco. Re: “*City of San Diego*; Interview of Paul Webster”. (Exhibit 50)

<sup>72</sup> 11 July 1004. Memorandum from Tim J. Deithloff to Paul S. Maco. Re: “*City of San Diego*; Interview of Paul Webster”. (Exhibit 50)

<sup>73</sup> 30 July, 2002 San Diego City Employees' Retirement System Annual Actuarial Valuation. P.17. (Exhibit 51)

<sup>75</sup> 11 July 1004. Memorandum from Tim J. Deithloff to Paul S. Maco. Re: “*City of San Diego*; Interview of Paul Webster”. (Exhibit 50)

retirement health care benefits) to be material because, if one were to look at the prospective amounts the City was paying in relation to their budget, there was no way the City could make 100% of the required payments.<sup>76</sup>

Despite this, Webber also admitted to Vinson & Elkins that he did not discuss what he knew to be material information with anyone from the City:

[T]he problem with it [the nondisclosure of the rising UAAL] is that they didn't tell the market and didn't consider the consequences (which is that they would eventually have to pay the debt). Mr. Webber did not recall talking to anyone at the City about the aforementioned comments.<sup>77</sup>

During that same year, and before Shipione's September 2003 e-mail, Orrick was tasked with analyzing and providing disclosure concerning the Gleason case. "Mr. Webber [himself] prepared a draft of the Gleason case disclosure based on the work of Luce Forward,"<sup>78</sup> a prominent San Diego law firm.

It is inconceivable that anyone could review the Gleason case, much less provide public disclosure regarding its import, without becoming aware of the City's underfunding of the pension.

It does not appear that Vinson & Elkins ever asked, much less followed up on, the question of why Orrick, possessing the knowledge it did, didn't act sooner, or why it had previously done nothing to correct the obvious incongruities in the bond offering documents, or why it claimed, apparently falsely, to be surprised by what it had supposedly learned for the first time in September 2003.

Perhaps the answer to these inquiries lies buried in Vinson & Elkins' own Report, where tucked away in footnote 350, is the following "disclosure":

Mr. Maco, a Vinson & Elkins partner who is also an author of this Report, had, prior to this time, provided Securities law advice to the City on a matter unrelated to the matters at issue here. He was asked by the City to also serve as a "sounding board" as the City prepared its pension disclosure [which was made on January

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<sup>76</sup> 8 March 2004. Memorandum from Benjamin S. Lippard to Paul S. Maco. Re: "*City of San Diego*; Interview of Paul Webber". (Exhibit 52)

<sup>77</sup> 8 March 2004. Memorandum from Benjamin S. Lippard to Paul S. Maco. Re: "*City of San Diego*; Interview of Paul Webber". (Exhibit 52)

<sup>78</sup> 11 July 2004. Memorandum from Tim J. Deithloff to Paul S. Maco. Re: "*City of San Diego*; Interview of Paul Webster. (Exhibit 50). 8 March 2004. Memorandum from Benjamin S. Lippard to Paul S. Maco. Re: "*City of San Diego*; Interview of Paul Webber" Luce Forward Hamilton & Scripps is a prominent San Diego law firm. (Exhibit 52)

27, 2004, before V&E began its investigation] and [was] asked as to whether the expansive disclosure advocated by Mr. Webber was appropriate. He concurred with Mr. Webber's judgment<sup>79</sup>

Thus, by Vinson & Elkins' own admission, even before it began its investigation, Vinson & Elkins had already served as Webber's "sounding board," leaving little room to wonder where Vinson & Elkins would end up after investigating Webber (and, by extension, itself).

#### **IV.**

#### **ACTIONABLE MISCONDUCT BY VINSON & ELKINS**

##### **A. BREACH OF CONTRACT**

The failures, omissions and shortcomings of Vinson & Elkins described in this Report fall squarely within a number of legally cognizable claims by the City. First, V&E breached its contracts with the City. Vinson & Elkins' consistent failure to comply with the terms of its Agreements with the City constitute actionable breach of contract.

Vinson & Elkins entered into at least two contractually binding Agreements for services with the City. These services included representation by Vinson & Elkins of the City in defense of the SEC investigation, the investigation and subsequent preparation of an objective and independent Report regarding the City's then – current and past financial disclosure practices; and then by extension of the City Council, the preparation of a second Report to correct the shortcomings of its initial Report ("Agreements"). Pursuant to these Agreements, Vinson & Elkins was required to comply with the applicable professional standards of care. Some of the more flagrant breaches of contract committed by V&E include:

- a. Failure to perform an investigation with an "initial scope" that "will be agreed upon by separate cover";
- b. Failure to prepare a Report that would "not be an advocacy document," but would be an "objective 'warts and all' report";
- c. Failure to prepare a second Report that adhered to the same objective and independent standards;
- d. Failure to perform work at a discount "in recognition of the governmental nature of the client";
- e. Charging the City for unnecessary work;

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<sup>79</sup> 16 September 2004. Vinson & Elkins: Report on Investigation: The City of San Diego, California's Disclosure Obligations to Find the Can Diego City Employees' Retirement System and Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code. p. 118. (Exhibit 53)

- f. Failure to limit the number of V&E partners and associate attorneys performing the work as specified;
- g. Failure to conduct an investigation into potential illegal acts by City and SDCERS; and
- h. Failure to conduct its investigation in a manner sufficient to meet the required professional auditing standards.

## **B. BREACH OF FIDUCIARY DUTY**

Second, Vinson & Elkins breached its fiduciary duty to the City. As a law firm, Vinson & Elkins owed its client, the City, fiduciary duties of uncompromising loyalty. As the City's fiduciary, Vinson & Elkins was required to disclose all information material to the City's interests; was required to put the City's interests above its own; and was required to exercise the greatest diligence in protecting the City. The fiduciary duty of loyalty required Vinson & Elkins to place the interests of the City, its beneficiary, over any personal interest of the firm. To the contrary, Vinson & Elkins placed its own interests over the interests of the City.

Evidence included in this report clearly illustrates that Vinson & Elkins breached its fiduciary duty to the City by, among other things:

- a. Inducing the City to retain it on the pretext that it would complete the work in two months and for \$150,000 (when V&E knew that it would charge the City substantially more and take substantially longer to complete the work it planned on doing);
- b. Inducing the City to retain it to perform an independent investigation, when it had already formed specific opinions, and even advised the City's Disclosure Counsel on recommended courses of action, before it began its investigation;
- c. Taking advantage of its own failure to prepare, and to conform its investigation to, an "initial scope" that would define the investigation it was to conduct;
- d. Charging the City for unnecessary legal work—\$6.2 million in fees (the equivalent of a well-paid attorney working 8 hours a day, 5 days a week, 50 weeks a year for ten years)—which was performed only to generate fees for V&E, not for any benefit that it would confer on the City; and
- e. Knowingly exceeding the City Council serial appropriations, made for V&E "to complete the report," when V&E knew full well that it had the City over a barrel and could continue to bill the City for what, effectively was unnecessary work to "pad" Vinson & Elkins' fundamentally flawed effort.



### **C. PROFESSIONAL NEGLIGENCE**

Third, Vinson & Elkins committed professional negligence. As its attorney, Vinson & Elkins owed the City a duty of care and skill in performing professional services on behalf of the City. Vinson & Elkins also had an obligation to comply with applicable professional standards. The conduct of Vinson & Elkins as described in this Report constituted a breach of its duty to exercise reasonable care and skill in performing accounting services for the City and as such, constitutes actionable professional negligence.

### **D. VIOLATIONS OF THE CALIFORNIA FALSE CLAIMS ACT**

Finally, Vinson & Elkins violated the California False Claims Act (California Government Code §§ 125650-125656). The False Claims Act, under specified circumstances, imposes civil liability for the submission of a false claim for payment to the City. Sections 125651(a)(1) and (2) apply to Vinson & Elkins by prohibiting the knowing submission of a false claim for payment to the City and the knowing use of a false record to get a false claim paid by the City. The term “knowing,” as defined by statute, includes actual knowledge, deliberate disregard and reckless disregard of the truth or falsity of the information.

Vinson & Elkins violated the False Claims Act by knowingly padding its bills for services to the City for work that was unauthorized and unnecessary. Vinson & Elkins also violated the False Claims Act by knowingly charging the city hourly rates that were higher than “governmental discount rates,” while representing that such rates were in fact discounted. In so doing, V&E opened itself up to treble damages in addition to civil penalties of up to \$10,000 for each false claim.

## **V.**

### **CONCLUSION**

Based upon the facts and circumstances set forth in this report it is the San Diego City Attorney’s considered judgment that the City should take appropriate legal action to recover the considerable damages proximately caused by Vinson & Elkins’ breach of duties owed to the City of San Diego.

By \_\_\_\_\_  
Michael J. Aguirre  
City Attorney